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Unclaimed Property ADVISORY ■

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Sailing the Sea Change of Delaware's New Escheats Law

On February 2, 2017, Delaware Governor John Carney signed Senate Bill 13 into law, completing a wholesale rewrite of the Delaware Escheats Law, codified at 12 Del. Code Ann. § 1130 et seq. The final version of the legislation changed little from the original bill introduced last month. The bill's single amendment made a handful of revisions, including removing "virtual currency" from the list of escheatable property and changing the timing for a holder currently under audit to opt into an expedited audit review process (and possibly also the timing for opting into the voluntary disclosure agreement (VDA) program). We summarized these changes in a blog post. Otherwise, SB 13 was signed by the governor in largely the same form as it was introduced.

Our prior advisory on SB 13 provides a review of many of the significant changes that the legislation makes to the Delaware Escheats Law. But there are some nuanced and unsettled issues raised by the new law, many of which holders—especially those currently under audit—will need to consider soon. The good news is that no final decisions likely need to be made right now. Nonetheless, it would be prudent for holders to begin the strategic decision-making process now in order to identify and vet all relevant factors and considerations.

Establishing Evidentiary Standards in Audits

The prior version of the Escheats Law did not directly address from an evidentiary perspective how the state could establish the existence of potential unclaimed property or how a holder could rebut the conclusion of unclaimed property. As a result, this issue frequently raised disputes between holders and the state and its contract auditors in rebutting a conclusion of unclaimed property.

However, as amended by SB 13, the Escheats Law now clearly establishes evidentiary standards that rely on the 2016 Uniform Unclaimed Property Act provisions. In particular, SB 13 provides that a "record showing an unpaid debt or undischarged obligation"—for example, an uncashed check—"is prima facie evidence of an obligation." A holder can overcome this prima-facie evidence "by establishing by a preponderance of the evidence" that:

(1) A check, draft, or similar instrument was issued as an unaccepted offer in settlement of an unliquidated amount.

(2) A check, draft, or similar instrument was issued but later was replaced with another instrument because the earlier instrument was lost or contained an error that was corrected.

(3) A check, draft, or similar instrument was issued to a party affiliated with the issuer.

(4) A check, draft, or similar instrument was paid, satisfied, or discharged.

(5) A check, draft, or similar instrument was issued in error.

(6) A check, draft, or similar instrument was issued without consideration.

This is a significant revision and should help to curb disputes in audits to some extent.

State Escheator's Ability to Enforce Information Requests

In *Marathon Petroleum Corp. v. Cook*, the Delaware federal district court held that Delaware lacked the authority to compel compliance with its audit information requests. Before being amended by SB 13, the Escheats Law provided the State Escheator with the power to issue a summons in the course of an audit; however, the law did not affirmatively provide the state with any enforcement mechanism. However, SB 13 apparently seeks to correct this lack of authority by granting the State Escheator the ability to issue an administrative subpoena to require a holder to produce requested records and bring an action in Delaware Chancery Court to enforce the subpoena.

How Does SB 13 Impact the Statute of Limitations?

SB 13 implements a 10-year statute of limitations for the state to seek payment of unclaimed property. The new statute of limitations runs from the date the duty was imposed, regardless of whether the holder submitted a report to Delaware. This is longer than the prior statute of limitations, which was three years from the date the report was filed or six years in the event of material underreporting—that is, for reports with an omission of unclaimed property that is more than 25 percent of the amount disclosed in the report. However, the prior statute of limitations did not begin to run for holders that did not file a report. SB 13 also adopts a tolling provision, which tolls the 10-year statute of limitations if a holder is contacted for audit or if the State Escheator reasonably concludes that the holder filed a report containing fraudulent or willful misrepresentation.

It is clear that the new statute of limitations will be beneficial to holders that have not previously filed a report where the three- or six-year statute of limitations did not apply. However, the new provision is clearly less favorable to holders that previously filed reports, although to the extent that the prior statute of limitations had already run for a holder that filed a report, SB 13 should not be able to re-open those years by adopting a longer limitations period.

How Will SB 13 Affect Estimation Methodologies?

SB 13 limits the State Escheator's ability to estimate holder liability in direct response to *Temple-Inland*, in which the federal district court held that Delaware's historical estimation practices were unconstitutional for various reasons, including that the methodology required consideration of unclaimed property owed to persons in states other than Delaware. In particular, SB 13 provides that the State Escheator may only estimate holder liability when the holder has not retained records for the new 10-year record retention period or has not filed unclaimed property reports during the lookback period.

The legislation does not, however, address the question on the minds of most holders, which is what estimation methodology will Delaware adopt. Instead, SB 13 directs the Secretary of Finance (in consultation with the Secretary of State) to promulgate estimation regulations that will apply to both audits and VDAs. Accordingly, holders are left waiting until perhaps as late as July 1, 2017, the deadline for the State Escheator to adopt such regulations, to gain any clarity on the estimation methodology. Nonetheless, we do not expect the regulations will deviate significantly from Delaware's historical methodology, under which the amount due to Delaware is extrapolated from unclaimed property owed to owners in all states and foreign countries. We do not expect that the state will adopt an "apportioned" state-by-state estimation methodology that only considers property owed to owners in Delaware in determining the error ratio, as suggested by the court in *Temple-Inland*.

What Will the Expedited Audit Review Process Look Like, and Why Would a Holder Opt Into It?

SB 13 permits holders currently under audit to opt into a new expedited audit review process. Under this process, if the holder responds to the auditor's requests "within the time and in the manner established by the State Escheator," the State Escheator must complete the audit within two years and waive all interest and penalties. The law gives the State Escheator complete discretion, subject only to review by the Secretary of Finance, to determine whether a holder has complied with the response requirements. Holders must opt into the expedited audit within 60 days of the Secretary of Finance's adoption of the estimation regulations. (The original bill required holders to request an expedited audit review by July 1, 2017.)

The State Escheator's broad discretion to administer the expedited audit review process creates significant uncertainties about how this process will work in practice. SB 13 gives the State Escheator the authority to establish how quickly and in what manner the holder must respond to the auditor's requests, which could be more cumbersome than current response requirements. And the State Escheator's complete discretion to determine if the holder has complied with these requirements means that a holder could be removed from the expedited audit review process with little warning and after good-faith attempts to comply with the requirements.

On the other hand, it does not appear that a holder under audit has anything to lose by opting into the expedited review process compared to simply staying in the current audit. After all, SB 13 mandates up to a 50 percent interest charge on assessments, only half of which is waivable, unless a holder completes the expedited review or opts into the VDA program, in which case interest and penalties are both fully waived. There do not appear to be any specific penalties or interest imposed in situations when the holder fails to complete the expedited review process, and it does not appear that a holder is precluded from opting out of the expedited process (back into the normal audit channel) at its discretion.

Is There Any Advantage to a VDA Now?

SB 13 gives holders currently under an audit that was authorized on or before July 22, 2015, an opportunity to convert their audit into a VDA with the Secretary of State under the existing VDA program, though the timing for doing so is somewhat unclear. The legislation has language that could be read as establishing a July 1, 2017, deadline and also language (which was inserted via the Senate amendment) that could be read as establishing a deadline of 60 days after adoption of the estimation regulations. We assume this is merely a drafting error and believe that the amendment was intended to provide the latter deadline (consistent with the expedited audit process election), but holders should be aware that ambiguity exists in the law.

But even if a holder can elect to convert its audit into a VDA, should it do so? In most other contexts (e.g., tax liabilities), voluntary disclosure programs provide clear benefits over audits to encourage voluntary compliance with the law. But under the Escheats Law as amended by SB 13, the VDA is not necessarily the obvious choice. In response to *Temple-Inland*, SB 13 creates a uniform 10-year lookback period for *both* audits and VDAs. Likewise, *both* audits and VDAs will use the same estimation methodologies, which are now under consideration by the State Escheator and Secretary of State.

In other words, it appears that the legislation is intended to harmonize the outcomes under both audits and VDAs from a substantive liability perspective. However, in an audit, the holder may have better luck negotiating a settlement on the estimation amount based on litigation hazards, given that any audit assessment is now immediately appealable to court. By contrast, a holder in the VDA program has no clear mechanism to challenge the results of the VDA (including any liability that is estimated) other than by withdrawing from the VDA program. Furthermore, most audits involve multiple states, and therefore if a holder opts into the Delaware VDA program, the holder will still need to continue the audit for the other states participating in the audit.

The chief advantage of the VDA under SB 13 is assurance of a complete waiver of interest and penalties for holders that complete the VDA process. Standard audits under the new law, by contrast, now carry interest of up to 50 percent of the value of late-reported property (although the State Escheator may wave up to half of that interest for good cause). In addition, the VDA program functions similarly to a managed audit in the tax context and therefore offers certain procedural advantages to an audit, including a greater degree of control than the standard audit process and a generally quicker resolution. In all cases, the decision to elect or avoid a VDA will depend on each holder's particular situation and risk tolerance.

Providing further complication, SB 13 does not address many significant uncertainties involved in the conversion of an audit to a VDA. For example, the legislation does not address how the work performed in the audit translates to the VDA. Will the VDA use the agreed-upon scoping from the audit? And what happens to a holder's audit file? Will the holder receive a copy from the auditor for use in the VDA? Or on the flip side, will the auditor forward the file to the Secretary of State, which might then use the file to challenge the holder's VDA submission? We understand the answer to the latter question is "no," but these questions have not been formally addressed and so put additional murkiness on the decision to forgo an audit in favor of a VDA.

Should Holders Not Yet Under Audit Consider a Proactive VDA?

Finally, SB 13 creates what appears to be a significant rollback in the protections provided to holders that are not yet under audit. Prior law provided that Delaware could not audit a holder without first notifying the holder that it could instead elect to enter the VDA program. SB 13 now provides that such a notice is not required if Delaware joins a multistate audit already initiated by another state. Presumably, this change is designed to encourage holders to consider enrolling in the Delaware VDA program even if they have not received an audit notice from Delaware since Delaware could potentially join another audit that could begin at any time.

Concluding Thoughts

As we have previously noted, SB 13 represents a sea change in Delaware's unclaimed property law. Even though the legislation appears in general to be holder-friendly and an overall improvement in the Escheats Law, there are a number of issues that could potentially be detrimental to holders. Thus, holders should continue to follow developments related to this legislation, including the forthcoming estimation regulations, as well as any guidance that the state issues related to opting out of an audit and into the VDA program (or into an expedited review).

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